Internal Revenue Service

memorandum

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to: Matthew Wallack
International Examiner

from: Carol Doran Klein, Chief, Branch 3
Office of Associate Chief Counsel (International) CC:INTL:Br3

subject: Transition rules under the Tax Reform Act of 1984

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This memorandum is in response to your request for assistance in a case concerning interest income of a CFC established to provide financing for its U.S. parent. The years in issue are 1985 and 1986.

For purposes of our discussion, we have assumed the following facts. P is a U.S. corporation that owns 100 percent of the stock of FS. P and FS use the calendar year as their taxable year. FS was established in 1980 with a $1000 capital contribution, which FS deposited in a foreign bank. FS's sole activity is borrowing from unrelated third parties and loaning the proceeds to P. In 1983, FS borrowed $5000 from an unrelated third party and loaned $5000 to P. In 1985, FS paid $250 of interest to the third party and received $260 of interest from P. In addition, P received $100 of interest income from its bank deposits in 1985.

FS's interest income for 1985 consists of U.S. and foreign source interest. FS must allocate its interest expense on a pro rata basis between its U.S. and foreign source interest income.[1]/

	US source interest	For. source interest
	$ 260	$ 100
Int. expense:	(180)	(70)
Net int. income:	80	30

The $30 of foreign source interest income may be includible in P's gross income under subpart F as separate limitation interest income under the look-through rules of section 904(d)(3) added to the Code in the Tax Reform Act of 1984 (P.L. 98-369).[2]/ The 1984 Act includes three transition rules, however, which may preclude the application of the look-through rules. We will first discuss the 1984 Act rules in general, and then apply them to the above facts.

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[1] See section 1.861-8(e)(2), Income Tax Regulations, as in effect in 1985. The regulations generally require a taxpayer to allocate interest expense among all of the taxpayer's income producing activities. Section 1.861-8(e)(2)(ii). Next, a taxpayer must apportion the interest expense deduction. The general rule is that interest expense is to be apportioned using an asset method, i.e., based on asset values. Section 1.861(e)(2)(v). The regulations, however, also provide two optional gross income method for apportioning interest expense. Section 1.861-8(e)(2)(vi). Under Option One, the taxpayer may use the gross income method if the result of using that method is that the amount of interest expense apportioned to the statutory groupings and residual grouping of gross income is at least 50 percent of what it would have been under the asset method. Under Option Two, if the conditions for Option One are not satisfied, the taxpayer may still use a gross income method if it apportions 50 percent of the amount that would have been apportioned to the statutory groupings and the residual grouping under the asset method to each of those groupings. For purposes of our facts, we have assumed that the taxpayer is able to use the gross income method provided in Option One.

[2] The $80 of U.S. source interest income may also be subpart F income to the U.S. shareholder. See section 952(b). If it is subpart F income, the look-through rules of section 904(g) and 904(d) may apply to the income.

1. Operation of the section 904(d)(3) transition rules in the Tax Reform Act of 1984.

Since 1962, section 904 has applied separately to certain interest income. Prior to 1984, taxpayers could easily avoid those rules by earning income that otherwise would have been treated as separate limitation interest through a related entity and converting the character of the income by repatriating the income in another form, e.g., a subpart F inclusion or a dividend. In the Tax Reform Act of 1984 (P.L. 98-369) ("the Act"), Congress added look-through rules for dividends and interest. The Act treats subpart F inclusions as dividends and consequently, they are also subject to the look-through rules. Section 122(a) of the Act, adding section 904(d)(3) of the Code.[3]/ Section 122(b) of the Act provides effective date rules. In general, the amendments made by section 122(a) take effect on the date of enactment of the Act (6/18/84). Section 122(b)(1). Three special effective date rules, however, apply to interest income.

Section 122(b)(2)(A) provides the general rule that interest income received or accrued by a "designated payor corporation" shall be taken into account for purposes of the amendment made by subsection (a) only in taxable years beginning after 6/18/84. If, however, the designated payor corporation receives or accrues interest after 6/18/84 but before the beginning of its first post-enactment taxable year, and that interest is attributable to an investment made after 6/22/84, the Act will apply. Section 122(b)(2)(B). Thus, interest on old investment is not subject to the look through rules until the designated payor corporation's 1985 taxable year but interest on new investments is immediately subject to the look-through rules adopted by the Act. A "designated payor corporation" is defined as a 50% U.S. owned foreign corporation, any other foreign corporation that has a U.S. shareholder at any time during the taxable year, or a regulated investment company. Section 904(d)(3)(E). The following example illustrates the application of these rules:

> Assume P, a U.S. corporation, owns 100 percent of the stock of FS, a foreign corporation. Both P and FS use the calendar year as their taxable year.

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[3] Unless otherwise specified all Code references are to the Internal Revenue Code of 1954, as amended by the Tax Reform Act of 1984.

(i) On 8/1/84, FS receives interest income on funds deposited in a foreign bank during 1983. The interest is included in P's gross income for its 1984 taxable year under subpart F. The look-through rules will not apply because FS received the interest before 1985 and the interest is attributable to an investment in place prior to 6/22/84.

(ii) On 8/15/84, FS deposited funds in a time deposit account in a foreign bank. On 9/1/84, FS receives interest attributable to its time deposit investment. The look-through rules will apply to treat the subpart F inclusion as separate limitation interest because although FS received the interest prior to 1985, the interest was attributable to an investment made after 6/22/84.

A third effective date rule applies for term obligations of a designated payor corporation that is not an "applicable CFC". Section 122(b)(3) of the Act provides that the look-through rules will not apply to any interest received or accrued on such a term obligation that the foreign corporation held on March 7, 1984. "Applicable CFC" is defined in section 121 of the Act (adding section 904(g) to the Code) to mean a CFC which (1) was in existence on March 31, 1984, and (2) the principle purpose of which on that date consisted of the issuing of CFC obligations or the holding of short-term obligations and lending the proceeds of such obligations to affiliates. Section 121(b)(2)(D). Essentially, an applicable CFC is one established to provide financing to related corporations. The conference report states that a "corporation will satisfy this principle purpose test if at least half of its liabilities on March 31, 1984, were CFC obligations and if at least half of its assets on that date were loans to affiliates." H.R. Rep. (Conf.) 98-861, 98th Cong., 2d Sess. 924. "Term obligation" is not defined in the Act but presumably refers to an obligation payable within a specified period of time. The following example illustrates the application of this rule:

Assume P, a U.S. corporation, owns 100 percent of the stock of FS, a foreign corporation. Both P and FS use the calendar year as their taxable year.

(i) FS is a manufacturing subsidiary established in 1980. On 3/1/84, FS loans $5000 to an unrelated third party. The loan is payable in 10 annual installments in arrears with 10 percent simple interest. FS thus receives $50 of interest income per year from 1985 through 1994.

FS is not an applicable CFC because although it holds a term obligation, its principle business is not holding term obligations and lending the proceeds to its affiliates. Because FS is not an applicable CFC and held the loan on 3/7/84, the effective date rule of section 122 (b)(3) applies. Thus, any interest income received on the loan and included in P's gross income under subpart F, whether received before or after 1985, will not be treated as separate limitation interest.

(ii) P established FS in 1980 with a capital contribution. FS deposited its capital in a foreign bank and earns interest on its deposit. On 3/1/84, FS loaned $5000 each to 100 unrelated third party. Each loan was payable in 10 annual installments in arrears with 10 percent simple interest. FS thus receives $5000 ($50 x 100) of interest income per year from 1985 through 1994. FS makes loans to P out of the interest income it receives. FS is an applicable CFC because its principle business consists of holding short-term obligations and lending the proceeds of such obligations to its affiliates. The effective date rule of section 122(b)(3), therefore, does not apply. The interest income FS receives after 1984 on the loans, that is includible in P's gross income under subpart F, will be treated as separate limitation interest income.

2. Effect of transition rules on the facts presented.

FS's first taxable year beginning after the date of enactment of the Act is 1985, and its interest income is not attributable to an investment made after 6/22/84. Thus, the transition rules of section 122(b)(2)(A) and (B) do not apply and the net foreign source interest income that FS receives in 1985 will be treated as separate limitation interest income unless section 122(b)(3) applies.

To answer that question, we must determine whether FS is an applicable CFC within the meaning of section 121(b)(2)(D) of the Act. Resolution of this issue requires a factual determination whether FS's principle purpose on March 31, 1984, was issuing CFC obligations or otherwise borrowing money and lending the proceeds to its affiliates. The conference report, discussed supra, indicates that a corporation will satisfy the principle purpose requirement if at least 50 percent of its liabilities on March 31, 1984, were CFC obligations and at least 50 percent of its assets on that date were loans to affiliates. FS's assets consist of a $1,000 bank deposit and a

$5,000 loan to P. At least 50 percent of FS's assets as of March 31, 1984 were loans to affiliates. The next issue is whether these loans are "CFC obligations" within the meaning of section 122(b)(2)(G).

Section 122(b)(2)(G) generally defines a "CFC obligation" as any obligation of (and issued by) a CFC that meets the requirements of section 163(f)(2)(B)(i) of the Code and, if issued after December 31, 1982, also meets the requirement of section 163(f)(2)(B)(ii). Section 163(f) denies an interest deduction on registration required obligations if they are not in registered form. Section 163(f)(2)(B) exempts obligations from registered form requirement if (i) there are arrangements reasonably designed to ensure that the obligation will be sold (or resold in connection with the original issue) only to a person who is not a United States person, and (ii) in the case of an obligation not in registered form, interest is payable only outside the United States and its possession, and there is a statement on the face of the obligation that any United States person who holds such obligation will be subject to limitation under the United States income tax laws.

Assuming that FS's obligations are CFC obligations, none of the special effective date rules preclude the application of section 904(d)(3) to the foreign source interest income FS receives in 1985. Thus, the $30 of net foreign source interest income that FS receives and that P includes in its gross income for 1985 under subpart F will be characterized as separate limitation interest income.

If you have any further questions, please contact Caren S. Shein at (202) 566-3452.